Anchor Small Cap Value and SMID Cap Value 2Q 2012 Investment Review

For the second quarter of 2012, Anchor's Small Cap Value composite returned -4.94%, and the Smid Cap Value composite returned -4.66%, compared with -3.01%, -3.47% and -3.02% for the Russell 2000 Value, the Russell 2000, and the Russell 2500 Value, respectively.

The second quarter featured more distress in US equity markets due to anxiety about the rolling European debt crisis, the confirmation of recession there, as well as reports of progressive weakening in the Chinese economy. Fear about the Obama health care plan's fate in the Supreme Court, and the cost ramifications for businesses also were priced into equities. The market seemed to echo summer 2011 by reflecting recession risk in many industrials and transports with an apparent rotation into Utility, REIT, and other dividend oriented stocks. Other thematic worries included the diminishing effect of possible subsequent QE asset purchases by the Fed, the ballooning US deficit, and the fiscal cliff with possible government spending cuts and higher tax rates.

With all those factors priced into US stocks, stock market action of the first few weeks of the third quarter improved, seeming to indicate that the US at least for the moment took on the role of relative safe haven, given that US corporations' balance sheets are cash rich, and that earnings prospects remain near peak levels notwithstanding any sales leakage due to Europe, and a stronger Dollar.

The Small and Smid sectors did reflect this redux of stock price weakness in the Aerospace and Defense sectors as well as some of the Capital Goods stocks in the second quarter. We are in the fourth year of a very fragile domestic recovery that has progressed without any real contribution from residential housing. Corporate and bank balance sheets are improved and consumer debt levels are also better even though individuals' net worth's and investment sponsors' balances have been set back given low interest rates and volatile stock portfolios.

In spite of the above challenges, the performance of corporate profits since 2009 has been quite good. The corresponding returns for our Small and Smid portfolios have been strong, and we have been in a consolidation phase since March. We do not believe that Europe's recession is pushing our economy into a recession, and modest firming of US employment levels supports this. The housing sector is beginning to stabilize as well. Also, $85 crude and low -$2.00 gas is like a subsidy that will enable some margin capture for many US companies in the next 18 months, along with relief in other commodity input prices. The Fed seems intent on keeping rates at levels which will compel investors out of cash and into financial and other assets. Small and Smid stocks can continue to be beneficiaries of this.

For the quarter, the strongest stock sectors were predictably, defensive ones, specifically, health care, and financials, in particular REITS. We have been underweighted in REITs in favor of banks at the present time. We gave up some relative performance for this in the quarter but this reflects our desire not to make indirect, leveraged bets on interest rates, and to own companies which are not reliant on accessing the stock or debt markets to fund their growth. Cap rates have trended quite low factoring into NAVs that challenge our criteria for valuations. Our overweight positioning in Technology in both the SMID and the SCV portfolios provided 100 basis points of relative outperformance in the quarter, owing to good stock selection. Other factors this quarter included some impact from our exposure to some individual Defense contractors and Transports which were hit in the market's reaction to Europe's recession as well as current US policy indications of reduced Defense spending. The Energy group was hit hard this quarter as well.

Top contributors to performance this quarter were in the Information Technology sector, including Web.com Group, Cymer, and Veeco Instruments. The two other top contributors to the quarter's results were in the Consumer group: Cato, a moderately priced retailer of women's apparel, and Wolverine Worldwide. Largest detractors in the quarter were Key Energy, a land rig service contractor, Greif, a diversified producer of packaging, Columbia Banking Systems, and two companies in the commercial and military aerospace sector, Esterline Technologies and AAR.

We remain fully invested, in companies which are self-sustaining with free cash flow, are able to defend or grow their market shares, and which provide goods or services to vibrant, well positioned customers and markets with favorable demand prospects. Strong dividend streams in a lot of cases are a plus if the companies' ROEs justify it and if payout ratios are low.

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